



Friday, September 25, 2009

Many Opinions – One Market

The stock market, since early March continues to suggest economic recovery. But this week it took a pause as the S&P 500 declined some 1.8%. Still, the average is 55% above its March 9th lows. With the huge rally, consensus seems to be building that the market is ahead of itself. Some even argue that we are in a sucker's rally or a bear market trap soon to collapse.

Perpetually pessimistic prognosticators such as the Wall Street Journal's E.S. Browning paint an ominous picture. In his article on Monday entitled "A Bear Market Lurks as Dow Nears 10000." Another, Barron's Alan Abelson quoted Stephanie Pomboy who believes that earnings expectations "have never been so far afield of economic reality." David Rosenberg, in a recent NY times article said that we were experiencing "an impressive bear-market rally," a short-term upturn in a "secular" bear market, that still had perhaps eight or nine years to run.

Dr. Ed Yardeni observes that the notion of a sucker's rally has been around since the rally started. He notes a story from the March 23rd issue of Forbes: "Is this a sucker's rally?" To answer the question, he takes another pessimist to task who happened to be right last September. Nouriel Roubini accurately predicted last September that a then-nascent rally would prove fool's gold. He was right, as the Standard & Poor's 500 has fallen 39% since then. Following that, he correctly predicted that rallies at the start of the year would also prove short-lived. Most recently he predicted, on March 12th, that the current rally, brewing since March 9th, would not last, fizzling under the 'onslaught of worst than expected macro news, earnings news and financial markets/firms shocks.' He missed that one, for now at least.

Another perennial pessimist is Jim Grant. But as Yardeni points out "he now sees greener pastures, with green shoots growing into green stalks, as they always do during recoveries." According to Yardeni, Grant bases much of his analysis on the work of Michael T. Darda, the chief economist of MKM Partners who is quoted as saying: "The most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period."

Indeed the S&P 500 is now trading more than 20% above its 200-day moving average—a feat only seen three times historically. Liz Ann Sonders Chief Investment Strategist for Schwab says that "although a near-term consolidation might be in order, the historical tendencies following such a feat have been quite healthy for the market (a 17% average return a year out)." She goes on to say that "with so many on the Street calling for a correction, we believe that it [the correction] might be in the form of time (relatively flat performance for a period) versus price (sharp weakness in a condensed period)."

If there is a common thread among many of the more pessimistic forecasters it is their rather myopic view of the economy. They tend to focus too heavily on the US ignoring what is going in the broader more relevant global marketplace – particularly the emerging marketplace.

Just today, world leaders announced that the Group of 20 nations is replacing the G-8 as the main forum for global economic coordination, reflecting a shift in power from rich countries to emerging markets. The decision comes as world leaders meet in Pittsburgh for their third summit in a year to improve the governance of the world economy following its near collapse. The G-8 will still exist and may meet on separate matters such as security, a US official said earlier. As noted by Bloomberg, the shift symbolizes the fact that the richest industrial nations now lack the sway to govern the world economy alone after their excesses sparked the turmoil that tipped the globe into recession.

In addition to lost influence there will likely be reduced energy in the developed economies of the 'Old World,' (the US, the UK, the Eurozone, and Japan). Dr. Yardeni says "they still matter, but less so than in the past. The economies of the New World are mattering more and more. They include the BRICs and other emerging economies, as well as the developed economies of Australia, Canada, South Africa, South Korea, and Taiwan."

It is likely that US stock investors are indeed taking a broader global view. While the US is not yet officially out of recession as many global countries are, domestic companies are benefitting from the resumption in global demand, as well as weakness in the US dollar. More than 40% of revenues of S&P 500 companies come from overseas. A weaker dollar boosts US exports and increases the dollar value of profits earned abroad by these companies.

So how bad is the declining dollar? As we have seen, it helps US exports. It has also helped US stocks. The trade-weighted dollar is down 11% since it peaked earlier this year, while the S&P 500 is up 53.9% over this period. Yardeni and others point out that since December of 2008 the Central banker policies have enabled carry traders to borrow at near-zero interest rates in Japan and in the US. Carry traders do well when the currency they borrow is depreciating relative to the currencies they buy explaining why a weak dollar should be bullish for foreign stock markets as well. As the most liquid currency on the planet, it is not about to lose its position as the world's store of value any time soon, regardless of the rather loud G-20 rhetoric.

Many expect the third quarter GDP report to show that the US economy emerged from recession. This week's economic data remains mostly constructive toward that view. A summary appears below:

- The index of leading economic indicators rose 0.6% in August on top of a 0.9% jump in July (revised up from 0.6%) and a 0.8% jump in June.
- US home prices rose 0.3% in July, according to the Federal Housing Finance Agency's monthly House Price Index.
- On a year-on-year basis, the House Price Index fell 4.2 percent in July—an improvement from down 5.3 percent in June. The U.S. index is 10.5 percent below its April 2007 peak. The FHFA monthly index is calculated using purchase prices of houses backing mortgages that have been sold to or guaranteed by Fannie Mae or Freddie Mac.

- Layoffs are declining. Initial jobless claims surprised economists to the downside for a third week in a row, down 21,000 in the Sept. 19 week to a 530,000 level. The four-week average, down 11,000 to 553,500, is at its lowest level since January.
- Existing home sales hiccupped yesterday after four months of gains, down 2.7% in August to a 5.10 million annual rate that fell well short of expectations of 5.35 million.
- Durable goods orders in August dropped a disappointing 2.4%, well below expectations and following a 4.8% surge in July. But excluding the transportation which fell 9.3% new durables orders were unchanged. Also, motor vehicle orders did not rise as much as expected after the cash-for-clunkers program drained auto inventories.
- New home sales surged 9.6% in July, following an upwardly revised 9.1% surge in June. The 433,000 annual unit pace was the best since September 2008. Importantly, the strong sales have been working down supply which is very good news for homebuilders. Supply is down to 7.5 months, the lowest level since April 2007 according to Bloomberg.
- The Reuters/University of Michigan consumer sentiment index rose more than 3 points from mid-month to 73.5, extending a run of momentum. The gain from the final August reading is nearly 8 points. Gains are split roughly evenly between the assessment of current conditions and the assessment of the outlook according to Bloomberg.

While signs are improving and the market is holding, many still believe we can fall back into recession. Some worry about the looming deficits and requisite rise in taxes. Others point to a rising sense of protectionism in the Congress. Art Laffer in an article in the WSJ yesterday titled “Taxes, Depression, and Our Current Troubles” he observed: “While Fed policy was undoubtedly important, it was not the primary cause of the Great Depression or the economy's relapse in 1937. The Smoot-Hawley tariff of June 1930 was the catalyst that got the whole process going. It was the largest single increase in taxes on trade during peacetime and precipitated massive retaliation by foreign governments on U.S. products. Huge federal and state tax increases in 1932 followed the initial decline in the economy thus doubling down on the impact of Smoot-Hawley. There were additional large tax increases in 1936 and 1937 that were the proximate cause of the economy's relapse in 1937.” It is troubling that the Administration chose to slap a tariff on tires imported from China on behalf of the steelworkers union and may do so for other industries. But similar skirmishes occurred during the Bush and Clinton Administrations without serious consequences. We hope for discretion.

The consensus before the financial meltdown was that the economy could withstand the housing recession and the sub-prime mortgage mess. They represented just a thin slice of the economy after all. Today's consensus suggests either a market correction or an extended period of flat prices while the economy and earnings catch up. They could be just as wrong.

We believe that earnings will be substantially better than expected as companies are extremely cost efficient now, American companies are benefitting from global sales abroad (exports) and historically low levels of inventory will have to be replaced, even on relatively low sales improvements. While we certainly don't invest our clients' money on market calls, for what it's worth, we believe the next major move will be up, not down. Have a good weekend.

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